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"My keenest interest is excited, not by what are called great questions and great cases, but by little decisions which the common run of selectors would pass by because they did not deal with the Constitution or a telephone company, yet which have in them the germ of some wider theory, and therefore of some profound interstitial change in the very tissue of the law."—OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 269 (1920).

## Comments

### CROPPER AND TENANT DISTINGUISHED IN MISSOURI

When an individual cultivates farm land not his own it often becomes necessary to ascertain the relationship which he occupies toward the owner. It may be that the cultivator will have possession of the land under either a written or oral agree-

ment. In this instance the cultivator is denominated a tenant, the owner a landlord, and the cultivator is said to hold upon lease.<sup>1</sup> On the other hand it may be that the cultivator does not hold an estate in the land but merely tends it for a consideration, which is many times a portion of the yield taken.<sup>2</sup> In such case the cultivator is defined as a cropper and takes no possessory interest in the land, but merely the rights of ingress and egress.<sup>3</sup> In both cases, the cultivation may be on shares of the crops.

Whether, in any given situation, the relation between owner and cultivator is that of landlord and tenant or owner and cropper will depend upon certain factors involved in the transaction.<sup>4</sup> It is the object of this Comment to indicate significant criteria for determining whether a particular cultivation agreement attains the dignity of a lease or merely constitutes a contract for personal service. The distinction is more than academically important. The tort liability of a possessor of land,<sup>5</sup> an employer's liability under the workmen's compensation law,<sup>6</sup> right to sue for ejectment<sup>7</sup> or trespass,<sup>8</sup> and other problems may turn on the distinction.

As indicated above, a lease is a transaction wherein the owner of an estate in land grants to another the right to possession, the former party retaining a reversion therein.<sup>9</sup> It is possible in Missouri for this relationship to arise from either an oral agreement or one reduced to writing.<sup>10</sup> The interest granted may be an estate for life, years, from period to period or at will, though in practice few leases are for life.<sup>11</sup> The lease for ninety-nine years is becoming quite popular in the case of city property because it involves certain benefits to both the lessor and lessee,<sup>12</sup> but, of course, it is seldom found in the case of agricultural lands.

1. *Marder v. Radford*, 229 Mo. App. 789, 84 S.W.2d 947 (K.C. Ct. App. 1935); *Williams v. Treece*, 184 Mo. App. 135, 168 S.W. 209 (St. L. Ct. App. 1914); *Whiteside v. Oasis Club*, 162 Mo. App. 502, 142 S.W. 752 (St. L. Ct. App. 1912); *State ex rel. Armour Packing Co. v. Dickmann*, 146 Mo. App. 396, 124 S.W. 29 (St. L. Ct. App. 1910); 1 AMERICAN LAW OF PROPERTY § 3.2 (1952).

2. *Pearson v. Lafferty*, 197 Mo. App. 123, 193 S.W. 40 (St. L. Ct. App. 1917); *Haggard v. Walker*, 132 Mo. App. 463, 111 S.W. 904 (K.C. Ct. App. 1908); 52 C.J.S. *Landlord and Tenant* § 797(c) (1947).

3. 1 AMERICAN LAW OF PROPERTY § 3.6 (1952).

4. *Id.* § 3.3.

5. *Lambert v. Jones*, 339 Mo. 677, 98 S.W.2d 752 (1936); *Walsh v. Southwestern Bell Tel. Co.*, 331 Mo. 118, 52 S.W.2d 839 (1932); *Shouse v. Dubinsky*, 38 S.W.2d 530 (K.C. Ct. App. 1931); *PROSSER, TORTS* § 75 (2d ed. 1955).

6. Under the Missouri Workmen's Compensation Law §§ 287.010-800, RSMo 1949, farm laborers are not covered, § 287.090(1)(2), RSMo 1949, unless their employer elects to accept the act, § 287.090(2). Of course the employer may incur common law liability toward his injured workers. Therefore many farm employers find it desirable to accept the act, since by so doing they become insulated against any and all common law claims arising from injuries to their employees. § 287.120(1), RSMo 1949.

7. 18 AM. JUR. *Ejectment* § 40 (1938); 28 C.J.S. *Ejectment* § 24 (1941).

8. 52 AM. JUR. *Trespass* § 25 (1944); 87 C.J.S. *Trespass* § 22 (1954).

9. 1 AMERICAN LAW OF PROPERTY § 3.2 (1952).

10. *Davis v. Gerson*, 219 S.W.2d 748 (K.C. Ct. App. 1949); *Vanderhoff v. Lawrence*, 201 S.W.2d 509 (K.C. Ct. App. 1947), *aff'd*, 206 S.W.2d 569 (Mo. 1947); *Coleman v. Fletcher*, 238 Mo. App. 813, 188 S.W.2d 959 (Spr. Ct. App. 1945).

11. 1 AMERICAN LAW OF PROPERTY § 3.2 (1952).

12. See 4 GILL, *REAL PROPERTY LAW IN MISSOURI* 1627-28 (1954).

Although generally leases may be created for any desired length of time, this is true in Missouri only if the formal statutory requisites of execution are observed. As indicated by the statute and cases decided thereunder, unless a lease is created in writing and signed by both the lessor and lessee, the result is only a tenancy at will.<sup>13</sup> One may well wonder whether a cultivator who enters under an informal lease and tends a crop, expecting to retain a percentage of the yield, is properly protected if he can be evicted at the will of the owner prior to harvest. To protect the tenant in this situation the Missouri courts early established by repeated decision that the tenancy at will of farming land created by statute becomes by common law a tenancy from year to year.<sup>14</sup> And by statute such tenancy can be terminated only upon written notice by either party given not less than sixty days next before the end of the year.<sup>15</sup> However, by judicial decision, this rule is limited to cases where no expiration date is agreed upon by the parties. If they agree upon a terminal date the lease will expire at that point without the necessity of notice to quit.<sup>16</sup> Thus, in Missouri, a written lease of farming land can be created for any desired duration. An oral lease of agricultural land becomes, by Missouri common law, a tenancy from year to year; and, where no terminal date is agreed upon, it can be terminated by at least sixty days written notice prior to the end of the agricultural year. Where an expiration date is agreed upon, the lessee's interest automatically expires on that date.

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13. § 432.050, RSMo 1949. The Missouri courts have made a strict literal interpretation of this statute, holding that upon failure of either party to sign, the result is a tenancy at will only. *Sinclair Ref. Co. v. Wyatt*, 347 Mo. 862, 149 S.W.2d 353 (1941); *Reid v. Gees*, 277 Mo. 556, 210 S.W. 878 (1919); *Midland Realty Co. v. Manzella*, 308 S.W.2d 326 (K.C. Ct. App. 1957); *Blake v. Shower*, 207 S.W.2d 775 (St. L. Ct. App. 1948). In *Midland Realty Co. v. Manzella*, *supra*, the Kansas City Court of Appeals held that though the signatures of both lessor and lessee are required, the lease itself need not be a single document; it may consist of a number of writings sufficiently connected so as to warrant their being read together. In that case a lease was held to be composed of: (1) a letter from the lessor, signed by him, to his duly authorized agent, ordering the latter to renew an existing lease with the lessee, (2) the agent's written offer of renewal to the lessee and (3) the "renewal lease" signed by the lessee only. The court in this case, at 331, emphasized that the intent of the legislature, in regard to the lease itself, was to require both the lessor and the lessee, or their agents lawfully authorized by writing, to sign the lease, even though a contract to make a lease could be specifically enforced if merely one party signed, provided that he was the party "to be charged." § 432.010, RSMo 1949.

14. *Kerr v. Clark*, 19 Mo. 132 (1853); *Ridgely v. Stillwell*, 28 Mo. 400 (1853); *Scully v. Murray*, 34 Mo. 420 (1864); *Vanderhoff v. Lawrence*, 201 S.W.2d 509 (K.C. Ct. App. 1947), *aff'd*, 206 S.W.2d 569 (Mo. 1947); *Coleman v. Fletcher*, 233 Mo. App. 813, 188 S.W.2d 959 (Spr. Ct. App. 1945); *Fisher v. Lape*, 176 S.W.2d 871 (Spr. Ct. App. 1944); *Hauer v. Harkreader*, 221 S.W. 813 (St. L. Ct. App. 1920); *Winter v. Spradling*, 163 Mo. App. 77, 145 S.W. 834 (Spr. Ct. App. 1912); *Womach v. Jenkins*, 128 Mo. App. 408, 107 S.W. 423 (K.C. Ct. App. 1908); *Kroeger v. Bohrer*, 116 Mo. App. 208, 91 S.W. 159 (St. L. Ct. App. 1905); *Hosli v. Yokel*, 58 Mo. App. 169 (St. L. Ct. App. 1894).

15. § 441.050, RSMo 1949.

16. *Vanderhoff v. Lawrence*, *supra* note 14, extensively considered in 13 Mo. L. Rev. 324-27 (1948); *Ray v. Blackman*, 120 Mo. App. 497, 97 S.W. 212 (St. L. Ct. App. 1906); *Butts v. Fox*, 96 Mo. App. 437, 70 S.W. 515 (K.C. Ct. App. 1902).

While a consideration of the problem of oral leases of city type property is beyond the scope of this Comment, it may be well to mention here that, by statute, oral leases of city type property in Missouri are treated as tenancies from month to month, terminable upon one month's written notice by either party.<sup>17</sup>

As has been previously pointed out, it may be that the agreement between owner and cultivator does not give rise to any possessory estate in the latter. His interest may be only a contractual right to some form of compensation for his services, that often being a percentage of the crop. In such instance the cultivator may be what is termed a "cropper." This individual has been defined as one who, having no interest in the land, is hired by the owner to cultivate it, receiving for his compensation a portion of the crops raised.<sup>18</sup>

No problem of distinguishing tenant from cropper ever arises if landowner and cultivator state in express terms what their relationship is intended to be. But this is frequently neglected and when such an arrangement comes under judicial scrutiny the courts are obliged to look to the subject matter, attendant facts and circumstances and the intention of the parties to determine the legal significance of their agreement.<sup>19</sup> The judicial task is increased by the fact that owner and cultivator generally agree to divide the yield in either situation.<sup>20</sup> Under such circumstances what factors do the courts consider? To what incidents do they attach significance?

In *Johnson v. Hoffman*,<sup>21</sup> the earliest Missouri case on the problem, the parties entered into a written agreement providing that Hoffman "leases, rents and lets unto" Johnson "for the term of three years, his farm" in St. Charles County. Johnson, signing by mark, agreed (1) to make necessary repairs and maintain the farm in good order, (2) to provide needed teams for cultivation, (3) to find all necessary seed during the first year, and half during the remaining two years, (4) to pay half the expense of dredging all grains sown on the farm and (5) to give up possession at the end of the term. Hoffman and Johnson were each to take half of "whatever may or will be raised on said farm for said three years." In a suit by Johnson for ejectment of Hoffman and possession of the farm the Supreme Court of Missouri unanimously held that, under this agreement, Johnson was to have possession of the farm for the specified period as tenant with Hoffman being his landlord. The decision was based upon the words "leases, rents and lets unto" and the promise of Johnson that he would give up possession at the end of the term. The court

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17. § 441.060, RSMo 1949.

18. *Maltbie v. Olds*, 88 Conn. 633, 92 Atl. 403 (1914); *Paulson v. Rogis*, 247 Iowa 893, 77 N.W.2d 33 (1956); *Wood v. Garrison*, 139 Ky. 603, 62 S.W. 728 (1901); *Hampton v. Struve*, 160 Neb. 305, 70 N.W.2d 74 (1955); *Empire Gas & Fuel Co. v. Denning*, 128 Okla. 145, 261 Pac. 929 (1927); *Wanamaker v. Buchanan*, 33 Pa. Super. 133 (1907).

19. *Gabel-Lockhart Co. v. Gabel*, 360 Mo. 518, 229 S.W.2d 539 (1950); *Paisley v. Lucas*, 346 Mo. 827, 143 S.W.2d 262 (1940); *Mecartney v. Guardian Trust Co.*, 274 Mo. 224, 202 S.W. 1131 (1918); *Thompson v. Lindsay*, 242 Mo. 53, 145 S.W. 472 (1912); *Donovan v. Boeck*, 217 Mo. 70, 116 S.W. 543 (1909).

20. 52 C.J.S. *Landlord and Tenant* § 793 (1947).

21. 53 Mo. 504, 506-07 (1873).

observed that Johnson could not surrender possession unless he had it, therefore the parties contemplated tenancy by Johnson. A decree in his favor was affirmed.

In *Moser v. Lower*<sup>22</sup> the parties agreed that Lower should plant and raise a crop on Moser's field, Lower to take one-third of the yield and Moser two-thirds. Lower's third was to be cribbed by Moser. After the harvest a dispute arose as to whether Lower was entitled to one-third of the stalks as pasturage. Moser argued that the stalks were part of the land and that Lower never gained any interest therein. The Kansas City Court of Appeals decided that Lower was not Moser's tenant, that Lower was a mere cropper without interest in or possession of the premises except for right of ingress and egress. Therefore he had no rights to the pasturage unless the stalks were considered so valuable that they could be said to be part of the crop, even though they were never taken off. The court felt that the parties had intended the stalks to be so treated and decreed that Lower should have his pasturage.

In both the *Johnson* and *Moser* cases it will be observed that in regard to the raising of the crop the duties of both cultivators were essentially the same. But in the latter case there was no mention of possession, no provision for the surrender of the land and no duties of repair or maintenance placed upon the cultivator. It may also be significant that the landowner was to crib the cultivator's share. This suggests a restricted sphere of activity by the cultivator, implying little, if any, in the way of possessory rights.

In *Haggard v. Walker*<sup>23</sup> the landowner was to furnish the land and seed, the cultivator was to break the land, sow the seed, cultivate, harvest and thresh. Each was to take an equal share of the yield. It was held that the cultivator was not a tenant but a mere cropper. Again there was no mention of possession, surrender or maintenance.

The St. Louis Court of Appeals held the cultivator to be a cropper in *Pearson v. Lafferty*,<sup>24</sup> where an oral agreement provided that owner and cultivator should share the yield equally. The cultivator did not live on the land, had no right thereto for any fixed period and had no privilege to exclude the owner.

*Jackson v. Knippel*<sup>25</sup> involved a written agreement wherein the owner "demised and leased" certain land to the cultivator for a year, the cultivator promising to pay half the yield as rent, to make necessary repairs and to deliver up the premises at the end of the term. The landowner was to furnish seed and fertilizer. The St. Louis Court of Appeals felt that a landlord-tenant relationship was created.

The problem arose again recently in *Hogue v. Wurdack*,<sup>26</sup> a case involving

22. 48 Mo. App. 85 (K.C. Ct. App. 1892).

23. 132 Mo. App. 463, 111 S.W. 904 (K.C. Ct. App. 1908).

24. 197 Mo. App. 123, 193 S.W. 40 (St. L. Ct. App. 1917).

25. 246 S.W. 1007 (St. L. Ct. App. 1923).

26. 298 S.W.2d 492 (Spr. Ct. App. 1957).

liability under the Missouri workmen's compensation law.<sup>27</sup> Hogue, tending Wurdack's farm under a written agreement, was seriously injured when, as he was mounting a trailer wheel, the rim blew off and struck him across the face. Wurdack, seeking to escape employer liability, argued that Hogue was a tenant, therefore not entitled to an award under the act.<sup>28</sup> Under the agreement Wurdack furnished the land, animals, equipment, buildings and fencing material. Hogue was to provide all labor, harvest the crop, tend the stock and make repairs. Hogue was provided with a house on the premises and was to take 40 per cent of the yield as "compensation for the above services." The Springfield Court of Appeals observed that the agreement referred to Wurdack and Hogue as "owner" and "tenant" respectively. Nevertheless the court held Hogue to be only a cropper, treating with significance the fact that Hogue's share was denominated "compensation" while Wurdack's share was nowhere referred to as rent. The court was unable to find that Hogue possessed an estate in the premises and observed that Wurdack remained in actual control of the farming operations.

With the preceding cases in mind certain factors consistently involved become noticeable and begin to crystallize into discernible legal standards. Thus it appears that in deciding whether a cultivator is a tenant or cropper the Missouri courts have looked to see:

1. Whether or not the operative words creating the relationship indicate a landlord-tenant relationship. (Key words may be "leases," "demises," "lets," "rents," etc.)
2. How much the cultivator is required to do. (The wider the scope of his control and privileges and the greater his discretion, the more likely he is to be held a tenant.)
3. Whether the cultivator agrees to surrender possession at the end of the term. (Such promise strongly indicates tenancy on the part of the cultivator.)
4. The terms in which the parties' shares of the yield are couched. (If the owner is to take a share as "rent," this indicates a lease; if the cultivator is to receive a portion as "compensation" this suggests a personal service contract.)

Courts in other states have looked to these and other factors in ruling on the problem. Some of the factors which have been held indicative of a landlord-tenant arrangement include a provision in the agreement prohibiting subletting,<sup>29</sup> a provision that the cultivator should not commit waste,<sup>30</sup> and a reservation by the owner of a right of re-entry if the cultivator violates certain covenants.<sup>31</sup> Courts

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27. §§ 287.010-.800, RSMo 1949.

28. § 287.040(2), RSMo 1949, seemingly exempts the landlord-tenant relationship from the effect of the Missouri workmen's compensation law unless it is created for the "fraudulent purpose of avoiding liability."

29. *Dolin v. Wachter*, 87 Mont. 466, 238 Pac. 616 (1930).

30. *Underhill v. Allis-Chalmers Mfg. Co.*, 15 F.2d 181 (8th Cir. 1926).

31. *Davis v. Burton*, 126 Mont. 137, 246 P.2d 236 (1952).

have found cropper agreements where the owner was to retain possession of the land and direct the planting of crops,<sup>32</sup> where the cultivator did not live on the land and had no exclusive control thereof,<sup>33</sup> and where the owner retained a right to possession of all crops until the cultivator performed all covenants required of him.<sup>34</sup>

Whether the cultivator is a tenant or cropper may, in the absence of contractual provisions, determine his right in the growing crops before division thereof.<sup>35</sup> In many jurisdictions a tenant on shares is, apart from the effect of statute, the owner of the crops until division whereas under a cropper agreement title to the products remains in the landowner.<sup>36</sup> However, a number of other jurisdictions regard the owner and cultivator as tenants in common or joint tenants of the crop, no matter what their relationship is in regard to the land.<sup>37</sup>

In Missouri a landlord-tenant relationship was held to give rise to a tenancy in common of the crop,<sup>38</sup> while under an owner-cropper agreement title to and possession of the entire crop was held to remain in the owner until a division thereof.<sup>39</sup> Thus in Missouri where the cultivation agreement creates only an owner-cropper relationship it appears that the cultivator cannot maintain a suit against the titleholder for conversion of the cultivator's share of the yield before division since he has no title to or right to possession of the crop prior to that time.<sup>40</sup> And where the arrangement is one of landlord and tenant and the former, by contract, seeks to retain a lien upon the latter's portion of the crop, it has been held that such provision operates as a chattel mortgage and must be recorded.<sup>41</sup> This would appear to be sound under the Missouri rule that a tenant is a tenant in common of the crops, if it can be said that growing crops are chattels. And the Missouri courts appear to so regard them.<sup>42</sup>

In conclusion it should be reasserted that the crucial difference between tenant and cropper is whether or not the cultivator has possession of the premises involved. The extrinsic factors surrounding the transaction are of value only insofar as they illumine the intention of the parties in regard to the matter of possession.

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32. *Taylor v. Donahoe*, 125 Wis. 513, 103 N.W. 1099 (1905).

33. *Sayles v. Wilson*, 31 Wyo. 55, 222 Pac. 1020 (1924).

34. *Gibbons v. Huntsinger*, 105 Mont. 562, 74 P.2d 443 (1937).

35. 52 C.J.S. *Landlord and Tenant* §§ 809-11 (1947).

36. *Id.* at § 809 nn.49-51.

37. *Id.* at § 810 nn.63-69.

38. *Kamerick v. Castleman*, 23 Mo. App. 481 (K.C. Ct. App. 1886).

39. *Morrill v. Alexander*, 215 S.W. 764 (K.C. Ct. App. 1919).

40. *Ibid.*

41. *Hardin v. Bank of Centralia*, 177 Mo. App. 44, 163 S.W. 306 (K.C. Ct. App. 1914); *Saunders v. Ohlhausen*, 127 Mo. App. 546, 106 S.W. 541 (K.C. Ct. App. 1903). § 443.460, RSMo 1949, provides that mortgages and deeds of trust of personal property must be recorded in order to be valid against anyone other than the parties thereto, except where possession of the chattels involved is delivered to and retained by the mortgagee or *cestui que trust*.

42. *Garth v. Caldwell*, 72 Mo. 622 (1880); *Hill v. Brothers*, 217 S.W. 581 (Spr. Ct. App. 1920); *Swafford v. Spratt*, 93 Mo. App. 631, 67 S.W. 701 (K.C. Ct. App. 1902); *Glass v. Blazer*, 91 Mo. App. 564 (K.C. Ct. App. 1901).



## FILING APPLICATION FOR FEDERAL TAX REFUND AFTER SIGNING FORM 870-AD, PROMISING NOT TO FILE

In accordance with the 1954 Internal Revenue Code provisions relating to closing agreements<sup>1</sup> and compromises<sup>2</sup> it is possible for the government to end all controversies over a disputed tax payment or deficiency. The finality of such agreements cannot be disregarded under any circumstances except those expressly provided.<sup>3</sup> However, the procedure followed in consummating the agreements is rather burdensome and for this reason, few of the controverted claims are closed in this manner.<sup>4</sup> Therefore, either a less burdensome procedure is followed or the disputed amounts are subjected to litigation.

Also contained within the 1954 Code are provisions restricting the manner in which deficiencies may be assessed.<sup>5</sup> It is possible however to waive these restrictions<sup>6</sup> and may be advisable to do so to stop the running of interest.<sup>7</sup> The form of this waiver has varied in the past but the essential provisions have remained unchanged.<sup>8</sup> One of the present forms on which the waiver may be effected is Form 870, which is not regarded as binding in the absence of special provisions but merely assents to the assessment of the deficiency. There is, however, another form that may be signed, after the taxpayer has obtained certain compromises on his liability, and that is Form 870-AD. This form contains a provision that the taxpayer shall not subsequently file application for refund or file suit, and is the child of confusion as to its binding effect. Neither of the above forms purports on its face to be a substitute for the statutory finality agreements and have express provision relating that very fact.<sup>9</sup>

These two agreements unlike the formal closing agreement or compromise, are concluded with relative simplicity and are therefore used to a considerable extent. This simplicity, however, along with the desire of the taxpayer to stop the six percent interest from accruing, the burdensome procedure of entering the formal closing agreement, and the eagerness of the government to avoid litigation form the nucleus of a troublesome area.

1. INT. REV. CODE of 1954, § 7121 providing for closing agreements is carried forward without substantial change from Revenue Act of 1928, ch. 852, § 606, 45 Stat. 874, as amended by Revenue Act of 1938, ch. 289, §§ 801, 802, 52 Stat. 573.

2. INT. REV. CODE of 1954, § 7122, relating to compromises is carried forward without substantial change from R.S. 3229, Revenue Act of 1934, ch. 277, § 112(b), 48 Stat. 759, Revenue Act of 1938, ch. 289, § 815, 52 Stat. 578.

3. INT. REV. CODE of 1954, § 7122, provides that the agreement shall not be reopened except upon a showing of fraud or malfeasance, or misrepresentation of a material fact.

4. Griswold, *Finality of Administrative Settlements in Tax Cases*, 57 HARV. L. REV. 912 (1944).

5. INT. REV. CODE of 1954, § 6213(a). Under this provision no assessment may be made for ninety days after a deficiency notice is mailed.

6. INT. REV. CODE of 1954, § 6213(d).

7. INT. REV. CODE of 1954, § 6601(d).

8. Prior to the present 870-AD the technical staff used Form 870-TS. Both of these forms contain a promise by the taxpayer not to reopen the case nor file a claim for refund.

9. The forms specifically state that they are not final closing agreements under INT. REV. CODE of 1954, § 7121.

The problem that is posed, simply stated is: "After signing Form 870-AD may a taxpayer subsequently file or prosecute an application for refund?" Before analyzing the courts' decisions in respect to this question, a further item should be mentioned that adds to the controversy. The item is the statute of limitations with respect to tax claims and deficiency assessments.

Under the 1954 Code, as originally enacted, the taxpayer had three years after the due date of the return to file for a refund, or two years after the payment date, whichever period was longer.<sup>10</sup> The government has three years after the date of filing the return in which to assess a deficiency.<sup>11</sup> The situation that can arise here, and often does arise, is that the taxpayer may pay pursuant to signing Form 870-AD, and if the statutory period has tolled against the government can file for refund after the government is barred from assessing a deficiency. As a result of this a further complicating factor is added to the conflict.

As may readily be observed there are four possible approaches which the court could conceivably follow to decide a case of this sort. The court could hold the agreement binding per se; or base the decision on estoppel; or allow equitable recoupment or set-off; or fail to accord the agreement any degree of finality. The inconsistency of the courts' decisions may be partially attributable either to the fact that all four of these alternatives have not been considered by the court or to the failure to insist upon the necessary elements of the alternative selected.

Solutions have been suggested to this dilemma,<sup>12</sup> but have resulted in little action.<sup>13</sup> Some effort extended by the treasury department has been regarded as solving the problem,<sup>14</sup> but the fact remains that the area is just as vulnerable to assailability, due to the above mentioned factors as before.

What is generally regarded as the predecessor of modern cases dealing with this subject is *Botany Worsted Mills v. United States*.<sup>15</sup> In reference to the agreement being binding per se, the court completely dispelled any such view stating: "When a statute limits a thing to be done in a particular mode, it includes the negative of any other mode."<sup>16</sup> The case has subsequently been regarded as standing for the proposi-

10. INT. REV. CODE of 1954, ch. 736, § 6511(a), 68A Stat. 730 (mended by 72 Stat. 1606 (1958) which now makes the three year period run from the time the return was filed).

11. INT. REV. CODE of 1954, ch. 736, § 6505(a), 68A Stat. 730 (amended by 72 Stat. 1606 (1958) which changed only the provisions relating to stamp taxes).

12. Griswold, *Finality of Administrative Settlements in Tax Cases*, 57 HARV. L. REV. 912 (1944).

13. The changing of the wording in INT. REV. CODE of 1954, § 7121 to "Secretary or his delegate" from the words "Secretary, the Under Secretary, or an Assistant Secretary," appearing in the 1939 Code, has had little effect upon the facility with which the claims may be handled.

14. Note, *Informal Tax Settlements—The Old Law and the New Procedure*, 23 U. CINC. L. REV. 214 (1954). As long as the agreement states it is not a formal closing agreement it cannot be accorded statutory finality.

15. 278 U.S. 282 (1929).

16. *Id.* at 289.

tion that unless a formal closing agreement or compromise is signed the agreement is not binding. This does of course accord with sound reason, for if the government is not bound by the agreement, than neither should the taxpayer be bound. The agreement appears to be bilateral in character. The government promises not to assess a further deficiency and the taxpayer promises not to file for refund. Since the promise by the government cannot be binding, due to the lack of authority to bind the government, it is difficult to see how a legally enforceable contract could ensue.

In the *Botany* case the issue of whether the taxpayer was estopped from asserting the non-finality of the agreement, due to the statute of limitations preventing the government from assessing a further deficiency, was not before the court. The court did not therefore authoritatively comment on the subject, but did state that it was not necessary to decide if estoppel could make such a non-binding agreement, binding under some circumstances. As the dissenting opinion in *Cain v. United States*<sup>17</sup> pointed out it is possible that the government was barred by the statute from assessing a deficiency, but since the matter was not considered the way was opened for the issue of estoppel.

The authority for the taxpayer not being estopped is *Joyce v. Gentsch*,<sup>18</sup> and the authority for estoppel is *Guggenheim v. United States*.<sup>19</sup> These two cases form the adversary views in the present opinions. In the *Joyce* case, in addition to the normal clauses relating to the promise not to file for refund, there was a provision providing that the government would not be barred from assessing a further deficiency. This clause was stricken in the *Guggenheim* case and has been used as a basis for distinguishing the two cases.

The *Joyce* case did recognize the possibility of recoupment but the *Guggenheim* case recognized neither set-off nor recoupment. The *Guggenheim* result appears to be illogical because two of the elements of estoppel are detriment and reliance. As to the detriment, if the government points to an actual loss in tax money, then it may recover by way of recoupment or set-off—therefore there is no detriment and thus no estoppel. As to reliance, it is difficult to see how the government may be justified in relying on the waiver when it is known, as a matter of law, that it is not binding.<sup>20</sup> However, the courts have allowed the defense of estoppel without even requiring that a detriment be shown other than the running of the statute. The courts allowing estoppel generally do not talk of recoupment or set-off.

In support of the argument that estoppel is inapplicable because there is no detriment is the recent case of *Arthur V. Davis*.<sup>21</sup> Recognizing that the agreement was the product of mutual concessions, the court also considered that it was difficult to see how the government would have conceded an amount it actually considered

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17. See the dissenting opinion in *Cain v. United States*, 255 F.2d 193, 199 (8th Cir. 1958).

18. 141 F.2d 891 (6th Cir. 1944).

19. 111 Ct. Cl. 165, 77 F. Supp. 186 (1948), cert. denied, 335 U.S. 908 (1949).

20. *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929).

21. 29 T.C. 878 (1958).

collectible. The court, after discussing this point, recognized that the agreement was not binding under the authority of the *Botany* case (therefore no reliance), and stated that even if a collectible item were conceded it could not be the detrimental element of estoppel, due to the availability of set-off. The distinguishing factor, of the express reservation to assess a further deficiency, used by some courts was stated to be no distinction at all as the government would have had that right, until the statute of limitations tolled against them, notwithstanding the clause. This appears to be a valid contention. The taxpayer knows that the party with whom he is contracting is not binding the government and that the government will be permitted to assess a deficiency if they later discover money is actually due. Therefore it is difficult to see how a clause expressly reserving this right to the government to assess a further deficiency would be necessary, or that the lack of it should create an estoppel situation.

Perhaps the strongest case exemplifying the availability of set-off precluding the defense of estoppel is *Cuba R.R. v. United States*.<sup>22</sup> The form in this case was exactly like that in the *Guggenheim* case. The facts do not present the issue of the statute of limitations but language in the decision leaves no doubt that it would matter little whether it had run or not. In holding that the government would not be precluded from asserting any claims it may have waived by accepting the form, due to set-off, the court held the form in that respect was a nullity. Asserting no valid grounds for estoppel appeared, judgment was for the taxpayer with an order allowing the government to plead a set-off of any claim it might have.

The court in the *Cuba* case, made the only justifiable decision that could be made. Realizing, however, that the decision was contrary to prior decisions in other courts on the matter, the court attempted to absolve the judiciary of the illogical inconsistency. This was done by placing the fault on the treasury department for failure to comply with statutory provision, or with Congress for setting forth the requirements that are stated in the Code. Suffice it to say at this point that if there were consistency in the courts' decisions there would be no reason to place the fault, as the issue would be settled.

Inconsistency is fully exemplified by contrasting the *Cuba* case and *Daugette v. Patterson*.<sup>23</sup> The form signed here was exactly the same as the form used in the *Cuba* and *Guggenheim* cases. Here, as in the *Guggenheim* case and contrary to the *Cuba* case, the court estopped the taxpayer from filing for a refund. Citing the *Guggenheim* case as authority, the court held that the tolling of the statute of limitations prevented the government from being in the same position as it was before and it would be inequitable to allow the taxpayer to recover. Just as in the *Guggenheim* case, set-off or recoupment was not mentioned. If the court is going to apply estoppel, there would appear to be some basis for ignoring set-off and recoupment. For example, if in a case such as the *Daugette* case, the taxpayer capriciously filed for a refund, with no

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22. 124 F. Supp. 182 (S.D.N.Y. 1954).

23. 250 F.2d 753 (5th Cir. 1957).

retroactive statute or subsequent judicial interpretation of a statute that was contrary to the interpretation at the time the agreement was consummated, then, in a sense of fairness, he could be estopped—if indeed, estoppel should be applied at all. But, if in a case where a retroactive statute were applicable, such as the *Guggenheim* case, the court were to search for a solution other than estoppel, a pattern of consistency might be ascertained. However, as is evidenced by these two cases, whether or not the taxpayer has ample reason for filing appears to be immaterial. The courts simply do not explore the possibilities and there is no factual or theoretical way to distinguish the cases.

In *Cain v. United States* the court states that the mere running of the statute would preclude the taxpayer from filing for a refund. However, the court then proceeds to note the inability of the government to deal with the situation other than by the use of estoppel. The facts do present a case that would casually appear to warrant estoppel, but in reality estoppel could not apply due to a lack of justifiable reliance. The case concerned a partnership profit distribution—the taxpayer of course claiming a smaller distributive share and the government alleging a larger share. After the statute had run the taxpayer filed for refund alleging a smaller share of the profit. Of course to assess one partner a smaller share meant the other partners would have to be assessed a larger share, and since the statute had tolled the government could not reopen the case against them. Therefore recoupment or set-off could not make the government whole.

The dissenting opinion in this case noted that justifiable reliance was not made out and that upon a proper interpretation of the facts the detriment alleged could be prevented from becoming real by use of recoupment.

Now, as to placing responsibility or fault for this incongruous and often anomalous situation, it must devolve upon the courts. Congress has provided a manner in which disputed tax claims may be settled. Congress has also provided the taxpayer with an opportunity to submit to an immediate assessment of a deficiency. The Treasury Department follows both statutes and cannot be condemned for setting up a defense of estoppel, even though it may fully realize the defense is without merit. The courts however in interpreting the cases, and the acts pursuant to the law, cannot in sound reasoning be justified in their decisions.

#### CONCLUSION

Injustice is often worked in the promulgation of a rule that is not tenable. The *Botany* case recognized fully the meaning of the statutes and is binding precedent to the effect that the agreement is not binding per se. The *Joyce* case next set a precedent, although not binding, for estoppel being inapplicable. However, the *Guggenheim* case appears oppressive and stimulated the promulgation of an untenable rule. Examining the principal elements of estoppel (reliance, detriment and misrepresentation), the knowledge of the parties with reference to the non-finality of the agreement, and the defenses of recoupment or set-off which are not barred as long

as the action being brought is timely,<sup>24</sup> the court was without merit in deciding as it did.

With reference to remedial action, it would appear there is no need for such action if a consistent pattern is followed by the courts. While it is true claims will still be litigated, a supreme load is being taken off the Treasury Department by allowing these agreements, as apparently only a small portion of the agreements are litigated. In effect, there would be much more litigation without the agreements, as the discretionary matter would eventually devolve upon the courts to be resolved. Here at least the parties have an opportunity to resolve the issue by mutual concessions. Realizing fully the finality of a closing agreement, both government and taxpayer are hesitant to sign due to its decisive effect, and a taxpayer would want to resort to every available alternative before signing such an agreement. As noted in the *Botany* case, such a decisive measure could not be entrusted to subordinate officials and with the present tax volume, a delegation of binding authority to many could easily have unsavory results. The taxpayer does not want to meet a vindictive government by contumaciously ignoring the agreement, and therefore few cases reach the courts where anything but a justifiable claim is presented. After being thus presented, the government, if possessed with a valid claim, may set it off against the application for refund. Much litigation is avoided by the agreement, but the courts appear oppressive and without justification in estopping the taxpayer.

In proper cases, where one of the following exist: misapplication of the law at the time the agreement was consummated, a retroactive statute applicable to matters considered in entering into the agreement, or facts subsequently appearing that render the agreement inequitable; then it would appear that the taxpayer is justified in filing a claim for refund. This would be true notwithstanding the fact that the statute of limitations had run against the government. If the claim must be litigated and the taxpayer properly presents the argument that the necessary elements of estoppel do not exist and that there is available to the government set-off or recoupment, then it would appear the taxpayer cannot be estopped to assert his claim.

JACK E. EVANS

### WATCH YOUR STEP ON THE WAY OUT—TAX SAVINGS ON SALE OF CORPORATE ASSETS UNDER SECTION 337, 1954 INT. REV. CODE

Section 337<sup>1</sup> may be used to obtain enormous tax savings upon a sale of corporate assets. For example: A corporation has book value assets of \$1,000,000 which have a market value of \$2,000,000. If the corporation sells these assets, in liquidation, it would be required to pay a maximum \$520,000 federal income tax.

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24. *Bull v. United States*, 295 U.S. 247 (1935).

1. INT. REV. CODE OF 1954, § 337. All section references hereafter will be to INT. REV. CODE OF 1954 unless otherwise noted.

If section 337 is properly employed, the corporation may avoid paying any federal income tax whatsoever on the \$1,000,000 gain. No lawyer can afford to ignore such benefits. Since there are many pitfalls along the path of section 337, this Comment is designed to show the way. The effects of Missouri statutes, including state income tax provisions, upon the use of section 337 must also be considered.

Section 337 is a step toward eliminating double taxation of gains made by corporations in the process of liquidation. The section on its face purports to completely end taxation of the corporation, regarding gains made upon liquidation, thereby resulting in only one tax being placed on such gains—a tax on the shareholder after distribution of the corporate assets. However, many problems arise in the quest for such nontaxable gain at the corporate level.

Before this section of the 1954 Internal Revenue Code was enacted the only way to avoid a taxable gain at the corporate level was for the corporation not to sell its assets, but to distribute them in kind to its shareholders. This method may still be valuable today, as will be discussed below. Of course, this is nearly impossible where the corporation has a large number of shareholders, scattered throughout the country. Also, there is a problem as to who will be treated as selling the assets, for tax purposes.

In *Commissioner v. Court Holding Co.*,<sup>2</sup> a closely held corporation (man and wife were the only shareholders) was held to have made a sale of an apartment building. The corporation had negotiations with the proposed purchasers and reached an oral agreement. On the day the parties met to reduce the agreement to writing, the corporation's attorney informed the parties that the corporation would have to pay a large tax on the gain involved. On the next day, a liquidating dividend was declared and the shareholders received title to the apartment building in exchange for their surrender of stock. A sale contract was then drawn naming the individual shareholders as the vendors, and the property was conveyed.

The tax court<sup>3</sup> found that the corporation had made the sale because the liquidating dividend was used to make the transaction look like something other than it was, to avoid tax liability. However, the circuit court of appeals<sup>4</sup> held that the sale had been called off by the corporation and the court treated the transaction as a sale by the shareholders. The Supreme Court reversed the court of appeals and affirmed the tax court, saying:

On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by

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2. 324 U.S. 331 (1945).

3. 2 T.C. 531 (1943).

4. 143 F.2d 823 (5th Cir. 1944).

using the latter as a conduit through which to pass title . . . [Citing cases.] To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

It is urged that respondent corporation never executed a written agreement, and that an oral agreement to sell land cannot be enforced in Florida because of the Statute of Frauds, Comp. Gen. Laws of Florida, 1927, vol. 3, § 5779. But the fact that respondent corporation itself never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation.<sup>5</sup>

Five years later, *United States v. Cumberland Pub. Serv. Co.*<sup>6</sup> was decided. In this case the purchaser made an offer to the corporation to buy its machinery. The corporation rejected the offer because of the heavy capital gains tax it would have been compelled to pay. The shareholders, desiring to save this corporate tax, offered to acquire the machinery, from the corporation and then sell it to the purchaser. The purchaser accepted. The corporation then transferred the machinery to the shareholders, its remaining assets were sold, and the corporation was dissolved. The shareholders then transferred title to the purchaser.

The court of claims<sup>7</sup> held that the sale was made by the shareholders; therefore, the gain was not taxable to the corporation. The Supreme Court granted certiorari<sup>8</sup> and affirmed the decision. The Supreme Court held that there was adequate evidence to support the findings of the trial court. The Court cited the *Court Holding Co.* case as authority for upholding the trial court's analyses and findings as regards the transaction.

The effects of the above two cases are questionable. Did they establish any limits within which one can fit a corporate liquidation and have no tax at the corporate level? Or, did the cases merely establish a procedural doctrine that the trial court's findings as to the transaction will be strongly followed by the appellate court? Whatever the cases do hold, the result is that any sale made by the shareholders, of assets received in corporate liquidation, is subject to the scrutiny of the courts and may well be held to be a sale by the corporation, in substance, and taxable as such.<sup>9</sup>

In view of this, it is rather risky to attempt a liquidation which will be tax-free at the corporate level. Therefore Congress passed section 337 under which a sale could be made at the corporate level without recognition of taxable gain to the

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5. 324 U.S. at 334.

6. 338 U.S. 451 (1950).

7. *Cumberland Pub. Serv. Co. v. United States*, 113 Ct. Cl. 460, 83 F. Supp. 843 (1949).

8. 338 U.S. 846 (1949).

9. *E.g., Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570 (2d Cir. 1949), *cert. denied* 338 U.S. 955 (1950); *Western & So. Life Ins. Co. v. United States*, ——— Ct. Cl. ———, 163 F. Supp. 827 (1958). *But see, e.g., Glenn v. Burley Tobacco Warehouse*, 207 F.2d 779 (6th Cir. 1953).



corporation. The Senate Committee report states, "Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties."<sup>10</sup> Section 337 did eliminate some uncertainties, but on the other hand, also created some new uncertainties. Therefore, the method of liquidation to which the *Court Holding Co.* and the *Cumberland* cases apply cannot now be merely ignored. Indeed, it may be wise to use this method in certain circumstances, as later explained.

#### SECTION 337

Section 337(a) states as a general rule:

If (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

The general rule looks simple and concise on its face, but its brevity has left many matters to speculation.

#### DATE OF ADOPTION

For purposes of determining whether corporate assets have been sold within 12 months after the adoption of the plan of liquidation, the exact date of adoption of such a plan of liquidation should be the date on which the holders of the majority of the outstanding shares adopted the plan. However, the regulations indicate that this may not be the result.<sup>11</sup>

The regulations provide that ordinarily the date of adoption of the plan of complete liquidation is "the date of adoption by the shareholders of the resolution authorizing the distribution of all the assets of the corporation . . . in redemption of all of its stock."<sup>12</sup> Then the two "ordinary" situations are stated: (1) When substantially all the assets are sold after the adoption of such a resolution (resulting in nonrecognition of gain or loss) and (2) when substantially all the assets are sold before the adoption of such a resolution (resulting in section 337 not being available and gain or loss recognized). But the ambiguous portion states: "In all other cases the date of the adoption of the plan of liquidation shall be determined from all the facts and circumstances."<sup>13</sup> (Emphasis added.)

Why has the date of adoption of such a plan as required by section 337(a) (1) been left open to speculation? The obvious reason is to prevent a corporation from selling its assets which will result in losses, charging the losses against the year's profits (or carrying them back against prior years' profits), and then adopting a plan of liquidation under section 337 to avoid recognizing gain on assets which have a market value higher than their basis to the corporation.<sup>14</sup> By leaving an open area

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10. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

11. Treas. Reg. § 1.337-2(b) (1955).

12. *Ibid.*

13. *Ibid.*

14. For ruling allowing operating loss deductions without adjustment for unrecognized gains under § 337, see Rev. Rul. 56-448, 1956-2 CUM. BULL. 130.

here, the Commissioner can hold that a plan of liquidation was adopted when these "loss-assets" were sold. Congress ostensibly intended such a result when it made provision for nonrecognition of both gains and losses under section 337(a). Therefore a corporation may, in a proper case, be held to have adopted a plan of complete liquidation before the shareholders have decided the issue. Such a holding could create sorrowful results to a corporation which innocently sold assets at a loss, then 30 days later adopted a plan of liquidation, and sold all its assets and distributed the proceeds 11 months and 20 days after the date of the shareholder's adoption. Only then could it be learned that the 12 month period started running 30 days before adoption by the shareholders and that some of the assets were sold 20 days after the 12 months had run. In this situation section 337 does not make provision for an equitable balancing of tax results. When this happens, the corporation has failed to qualify under section 337 and therefore does not get the benefits, at all, of the non-recognition of gain provision. If the liquidation happens to be complete within 12 months from the date of the sale of the "loss-assets", then the gain made on the other assets will not be recognized, but neither will the losses be deductible.

Whether this flexible method of determining when the plan was adopted is good or bad, is beyond the scope of this Comment. However, summarily, it seems that the courts would be stretching somewhat to hold that a sale of assets, with a subsequent adoption of a plan of liquidation by the shareholders, tends to show adoption of any plan of liquidation at the point of sale. How does such corporate action show adoption of a plan, at the point of sale, to liquidate assets and distribute the proceeds in exchange for stock outstanding. Also, how can such circumstances show that, at the date of sale of the assets, a plan of complete liquidation was adopted?<sup>15</sup> The regulations surely do not eliminate "uncertainties".

The statutory procedure in Missouri for dissolution of a corporation creates even more problems in determining such date of adoption. It provides that voluntary dissolution may be had by written consent of the holders of record of all the corporation's outstanding shares<sup>16</sup> or by the board of directors adopting a resolution recommending dissolution and the holders of two-thirds of the outstanding shares adopting the resolution.<sup>17</sup> The question arising here is at what point the adoption concerning section 337 will be held to have been made if the latter method is used: At the time (1) of a sale of a corporate asset resulting in a loss, (2) when the directors adopt a resolution recommending dissolution, or (3) when the holders of two-thirds of the outstanding shares adopt a resolution to dissolve.

*Virginia Ice & Freezing Corp.*<sup>18</sup> sheds some light on this problem, since the Virginia statute<sup>19</sup> is similar to Missouri's.<sup>20</sup> The directors there sold two of the

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15. Paulston, *How to Plan and Execute the Sale of a Corporate Business Under the Internal Revenue Code of 1954*, U. So. CAL. 1956 TAX INST. 383, 418-19.

16. § 351.460, RSMo 1949.

17. § 351.465, RSMo 1949.

18. 30 T.C. No. 132 (Sept. 26, 1958).

19. Va. Acts 1922, ch. 380, § 3810.

20. § 351.465, RSMo 1949.

corporation's eight plants, one on October 1, 1954, and other on October 4, 1954; both plants being sold at a loss. On October 1, 1954, the same day as the first loss sale, the directors in accordance with the Virginia statute<sup>21</sup> issued a notice to themselves of a meeting of the board to consider dissolution on October 11, 1954. The directors adopted a resolution to dissolve, and under the Virginia statute,<sup>22</sup> sent a notice to all shareholders of a meeting on October 22, 1954. The plan of liquidation was adopted at this meeting on October 22. The liquidation of the corporation's remaining six ice plants was made with a substantial gain and the proceeds were distributed to the shareholders by September 20, 1955. By vote of the shareholders, the corporation was dissolved on September 20, 1955. On its tax return for 1954 the corporation deducted the loss on the two plants sold on October 1 and 4, 1954, but the Commissioner disallowed the deduction, claiming that these two sales at a loss were part of a plan of complete liquidation and therefore the loss could not be recognized under section 337. The tax court said:

It is our opinion that petitioner [the corporation] did not adopt a plan of complete liquidation prior to the meeting of stockholders on October 22, 1954. Until then there was no assurance that the recommendation of the board of directors passed on October 11, 1954, would be adopted by the stockholders. Even if the date the directors acted, viz, October 11, 1954, is significant, it was at a date subsequent to the dates on which . . . [the two plants which rendered a loss] were sold.

We hold, therefore, that at the time the . . . [two plants] were sold, petitioner had not yet adopted a plan of complete liquidation and that these sales are not controlled by section 337 of the International Revenue Code of 1954.<sup>23</sup>

This case shows reluctance by the court to hold that the date of adoption of a plan of complete liquidation is the date of the sale of some corporate assets. However, the court recognizes the possibility that the plan might be held to have been adopted when the directors approved a resolution to dissolve under the Virginia statute.<sup>24</sup>

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21. Va. Acts 1922, ch. 380, § 3810. This section requires a ten-day notice of a meeting of the board of directors to consider dissolution.

22. *Ibid.* The statute requires a fifteen-day notice, to be sent to every shareholder, of a meeting to consider dissolving the corporation.

23. 30 T.C. at —. The Commissioner has not yet indicated whether he will acquiesce this decision.

24. Va. Acts 1922, ch. 380, § 3810. This statute says, "Whenever in the judgment of the board of directors it shall be deemed advisable and for the benefit of any corporation . . . that it shall be dissolved, a resolution to that effect shall be adopted by a majority of the whole board. . . ." Then the statute requires two-thirds in interest of the shareholders to "consent" to the proposed dissolution. § 351.465, RSMo 1949, however, provides that the board of directors shall adopt merely a resolution "recommending" dissolution and directs that the "question" of such dissolution be submitted to a vote of the shareholders. Then, at the shareholders meeting, an affirmative vote of holders of two-thirds of the outstanding shares is required for "adoption" of a "resolution to dissolve." The Virginia statute could be taken to give more power to the directors than the Missouri statute and therefore it is probably less likely that the directors, in Missouri, would be held to have adopted a plan of

There have been no cases or rulings to date where a corporation has been held to have adopted a plan of complete liquidation at any other time than the date on which the shareholders have voted to adopt such a plan.<sup>25</sup> Also, there have been a few situations in which the corporation has been held to have adopted the plan when the shareholders passed on it, in the face of other events which might well have been used as the date of adoption for section 337 purposes.<sup>26</sup> However, the risk still exists that some event other than the adoption by the shareholders may be held to be the date of adoption for section 337 application.

Based on *Virginia Ice & Freezing Corp.*, it seems that it would be safe in Missouri to rely on adoption of a plan of complete liquidation being held to be at no earlier date than its passage by the board of directors. Therefore, any sales made before such date would not subject the corporation to the risk of losing a loss deduction or of not being able to use section 337. However, the facts must be indistinguishable from the *Virginia Ice & Freezing Corp.* case. As small a change as selling assets at a loss before adoption of a plan by the shareholders, *under advice of counsel*, may be enough for the date of adoption to be held to be the date of sale of the "loss-assets". Merely the corporation's awareness of the possibility of a tax saving by this procedure, may be enough to result in an adverse ruling.<sup>27</sup>

The absolutely safe method would be refrain from having any sales of corporate assets which are not ordinary, everyday transactions prior to adoption of a plan of complete liquidation by the shareholders and to accomplish the complete liquidation of the corporate assets within 12 months after the date that the directors<sup>28</sup> passed on the plan of liquidation.

Another problem that may arise under section 337(a) is whether the corporation actually did adopt a plan of complete liquidation. If questioned, of course, the corporation will have the burden of proving such adoption. Formal minutes should be drawn of the shareholders' meeting at which resolutions, similar to the ones in *Virginia Ice & Freezing Corp.*, are passed.<sup>29</sup>

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complete liquidation as required by § 337. See also Rev. Rul. 57-140, 1957-1 CUM. BULL. 118.

25. But cf. Rev. Rul. 58-391, 1958 INT. REV. BULL. No. 32, at 6, where an unincorporated employees' club (treated as a corporation for tax purposes) was held to have adopted a plan of complete liquidation on the date that the board of directors adopted such plan. In this situation, however, the members of the club had previously contracted to give the directors complete control and therefore had no power to adopt such a plan.

26. *Virginia Ice & Freezing Corp.*, 30 T.C. No. 132 (Sept. 26, 1958); Rev. Rul. 57-140, 1957-1 CUM. BULL. 118.

27. MERTENS, FEDERAL INCOME TAXATION, CODE COMMENTARY § 337(a): 1 (1955).

28. Using this date will eliminate any question under § 351.465, RSMo 1949, as to whether the date of adoption by the directors or the shareholders is the date to be used for the purposes of § 337.

29. Treas. Reg. § 1.337-5(a) (1955) requires that a copy of these minutes (including a copy of the plan of liquidation itself) be filed with the corporation's tax return. Also, note the § 6043 requirement that notice of liquidation must be filed within 30 days after adoption of the liquidation plan.

Also, it would seem that filing the articles of dissolution with the Secretary of State, as required by Missouri statute,<sup>30</sup> would satisfy entirely the corporation's burden of proof.

However, it may not always be advisable to use such filing with the Secretary of State as proof of adpotion.<sup>31</sup> Under Missouri statute,<sup>32</sup> the corporation must cease to do business except as necessary for the winding up thereof, upon such filing. Therefore, it seems that a manufacturing corporation, for example, might have to shut down its factories at the time of filing.<sup>33</sup>

#### DISTRIBUTION IN COMPLETE LIQUIDATION, LESS ASSETS RETAINED TO MEET CLAIMS

Many problems may also arise in applying section 337(a) (2). All of the corporate assets, except those retained to meet claims, must be distributed in complete liquidation within the 12 month period. The most important consideration here is determining exactly when the 12 month period actually begins and ends, as discussed above. However, there are other situations that could affect a corporation's ability to comply with section 337(a) (2).<sup>34</sup>

What would happen if the corporation could not find anyone to buy the assets within the 12 month period? If the shares in the corporation are widely owned, it may be very difficult to distribute the assets, in kind. The corporation could convey the assets to a trustee who would hold the assets for the shareholders, but this may not be upheld by the courts as a distribution for purposes of section 337(a) (2). There is a possibility that such a trustee will be held to be an agent of the corporation, the result being a finding that there was no distribution of the assets to the shareholders. The Senate Committee clearly states that it is intended that all property, except that retained to meet claims, must be distributed to the shareholders.<sup>35</sup>

The safe solution here is for the corporation to find the proposed purchasers in

30. § 351.470, RSMo 1949.

31. If, however, § 351.470, RSMo 1949, is taken to require the corporation to file with the secretary of state before taking any kind of action toward liquidation, it will always be necessary to file the articles of dissolution. Such interpretation could prevent negotiations for sale of the corporate assets or even the adoption of a plan of complete liquidation, until the corporation first files the articles.

32. § 351.470, RSMo 1949.

33. There is a possibility that this statute will not be interpreted as proposed in the text. "[E]xcept as insofar as may be necessary for the proper winding up thereof" may be taken to include the normal operation of the corporation's business until a suitable purchaser is found and the sale of the assets is made. On the other hand, if the statute does mean that the corporation must cease its ordinary operation, the corporation would want to sell the assets as soon after such filing as possible. A problem arises here in that the statute, interpreted as discussed at note 31 *supra*, may be taken to mean that no negotiations for sale may occur until after such filing. This would make it extremely difficult to arrange such a sale.

34. An interesting problem arises under Rev. Rul. 56-387, 1956-2 CUM. BULL. 189 holding that where all the corporate assets have been used to pay creditors, the corporation cannot use § 337 because there has been no distribution to shareholders threatening double taxation.

35. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

advance of the adoption of the plan of liquidation. The regulations specifically allow such prior negotiations.<sup>36</sup>

It would be advisable in Missouri, but not absolutely necessary, to obtain a certificate of dissolution from the Secretary of State<sup>37</sup> as proof of complete distribution to shareholders within the 12 month period. Since Missouri statutes require, for issuance of such certificate, that all obligations of the corporation must be paid or provide for, and all the remaining property be distributed to its shareholders,<sup>38</sup> such certificate should be acceptable as proof of a distribution in complete liquidation.

Under section 337(a)(2) the corporation is allowed to retain assets to meet claims and still qualify for the nonrecognition of gain benefits. The regulations require that such assets "must be specifically set apart for that purpose and must be reasonable in amount in relation to the items involved";<sup>39</sup> and also that "such arrangements for payment must be made in good faith."<sup>40</sup>

It would probably be advisable to retain cash only, for payment of outstanding claims against the corporation. Other assets may produce income while they are being held and thereby result in an excess of assets being retained by the corporation and the corporation being held to have not distributed all of its assets within the 12-month period. Also, if such income is similar to the type produced in the ordinary course of business, the corporation may be viewed as still doing business and as not sincerely adopting a plan of complete liquidation as required by section 337(a)(1).<sup>41</sup>

Aside from this income, there do not seem to be many other problems involved in retaining assets to pay *known* liabilities and liquidating expenses,<sup>42</sup> if such amounts are reasonable and retained in good faith. The necessarily ambiguous area, however, is the retention of assets to pay *contingent* liabilities and expenses.

The same regulations apply to contingent liabilities and expenses as to known liabilities and expenses.<sup>43</sup> However, compliance with these regulations is much more difficult concerning contingencies. Not only must a retention of assets for contingencies be in good faith,<sup>44</sup> but such assets must be reasonable in amount and specifically set apart.<sup>45</sup>

36. Treas. Reg. § 1.337-2(a) (1955). However, the corporation still must be cautious not to go beyond "negotiations".

37. § 351.480, RSMo 1949.

38. § 351.475 RSMo 1949.

39. Treas. Reg. § 1.337-1 (1955).

40. Treas. Reg. § 1.337-2(b) (1955).

41. Of course even cash may produce income in some situations; therefore, it would seem advisable to carefully manage cash so as not to have any income.

42. Treas. Reg. § 1.337-2(b) (1955).

43. Treas. Reg. §§ 1.337-1, -2(b) (1955).

44. Treas. Reg. § 1.337-2 (1955).

45. An interesting problem in this area is whether a corporation should retain assets for a contingent tax liability that may be assessed on prior years' returns. Treas. Reg. § 1.337-5(d) (1955) requires a statement of assets retained to pay liabilities and the nature of the liabilities.

The reasonable amount of assets that need be retained for contingencies would seem to be very difficult to determine. What would such determination be based upon if a personal injury suit was pending against the corporation when it wished to distribute its assets to the shareholders? In some cases, the corporation will just have to guess what amount will be held to be reasonable. Such a nebulous rule makes this area very dangerous, especially when considering the risk involved in noncompliance, i.e., losing *entirely* the benefits of section 337.<sup>46</sup>

There is nothing specifically mentioned in section 337 about contingent liabilities or expenses. If the word "claims" in section 337 does not include contingent liabilities,<sup>47</sup> it would seem unlikely under Missouri statutes<sup>48</sup> that a corporation, which had such liabilities, could qualify for use of this section. The statutes say that after the filing of the articles of dissolution by the Secretary of State

... the corporation shall proceed to collect its assets, convey and dispose of its properties, pay, satisfy, and discharge its liabilities and obligations and do all other acts required to liquidate its business and affairs, and *after* paying or adequately providing for the payment of *all* its obligations, distribute the remainder of its assets ... among its shareholders. ...<sup>49</sup> (Emphasis added.)

It would seem that the above statute includes contingent liabilities when it says "all its obligations."<sup>50</sup> It is a possibility, therefore, that without the rule established by the regulations,<sup>51</sup> allowing retention of assets for contingent liabilities, Missouri corporations would not be able to obtain section 337 benefits.

Apparently, under the Missouri statute<sup>52</sup> a corporation with outstanding liabilities, either known, contingent, or both, may not be able to use the route of the *Cumberland* case to avoid double taxation on *all* its assets if they *all* have appreciated values. It would seem that the corporation must pay, or adequately provide for payment of, its obligations *before* it could distribute assets to the shareholders.<sup>53</sup> The corporation, therefore, would be forced to recognize gain on those assets used to pay its obligations, since it could not distribute those assets to the shareholders.

46. See Shaw, *Corporate Distributions, Liquidations and Reorganizations*, 32 DICTA 109, 119 (1955). This article proposes that to be safe the corporation not retain assets for satisfaction of contingent liabilities but that the assets should be distributed and the shareholders allowed to assume any risk that cannot be finally determined within the twelve month period. See also Colborn, Fleming, Katcher, and Merritt, *Buying and Selling A Corporate Business: A Survey of Tax and Non-Tax Implications*, 10 W. RES. L. REV. 123, 141 (1959).

47. See *Benoist v. Murrin*, 47 Mo. 537 (1871); *In re Balfour & Garrette*, 14 Cal. App. 261, 111 Pac. 615 (Ct. App. 1910), where "claim" is held to include a contingent liability. But see *Dunnigan v. Stevens*, 19 Ill. App. 310 (1885) where contingent liabilities are held not to be "claims".

48. § 351.470, RSMo 1949.

49. *Ibid.*

50. See *In re Balfour & Garrette*, 14 Cal. App. 261, 111 Pac. 615 (Ct. App. 1910), decided under CAL. CIV. PROC. CODE. § 1228 (1915); *Reinfeld v. Fidelity Union Trust Co.*, 123 N.J. Eq. 428, 198 Atl. 220 (Ch. 1938) decided under N.J. REV. STAT. 14:13-1 to -15 (1937).

51. Treas. Reg. §§ 1.337-1, -2(b) (1955).

52. § 351.470, RSMo 1949.

53. The theory of Shaw, *supra* note 46, would probably not be applicable in Missouri.

It seems to follow that a Missouri corporation with contingent liabilities and expenses outstanding can *fully* avoid double taxation on gains on sales of assets, made in liquidation, *only* by means of section 337 and the accompanying regulations.

Though section 337(a) (2) allows a corporation to retain assets to meet claims, the regulations state that "no amount may be set aside to meet claims of shareholders with respect to their stock."<sup>54</sup> As to shareholders who cannot be found within the 12 month period the regulations provide that "a distribution in liquidation includes a transfer to a State official, trustee, or other person authorized by law to receive distribution for the benefit of such shareholders."<sup>55</sup>

There may be a problem in Missouri concerning missing shareholders, if the corporation wishes to obtain a certificate of dissolution as proof of a distribution in complete liquidation. The statutes require<sup>56</sup> that all the property and assets of the corporation be distributed to the shareholders before articles of liquidation can be filed and the certificate obtained. Whether a transfer to a "State official, trustee, or other person authorized by law to receive distributions for the benefit of such shareholders"<sup>57</sup> will satisfy this statutory requirement is questionable. A Missouri corporation, therefore, may well have to go without such fine proof as a certificate of dissolution; therefore, it should provide for adequate records and witnesses to prove that the corporation met the 12 month period limitation for a distribution in complete liquidation.

A problem could arise in meeting the distribution in complete liquidation clause of section 337(a) (2) when substantially all of the shareholders form a new corporation and continue to use assets of the liquidated corporation. If almost all of the liquidating corporation's assets were used by the new corporation, it might well be held that there had been, in substance, no distribution in complete liquidation.<sup>58</sup>

#### SALE OR EXCHANGE

Section 337(a) provides for nonrecognition of gain or loss only on *sales or exchanges* of property<sup>59</sup> by the corporation within the 12 month period following adoption of the plan of complete liquidation. Therefore, whether there was a sale or exchange and whether it occurred within such period are problems that need to be considered.

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54. Treas. Reg. § 1.337-2(b) (1955). See also Rev. Rul. 57-140, 1957-1 CUM. BULL. 118.

55. Treas. Reg. § 1.337-2(b) (1955).

56. §§ 351.475-.480, RSMo 1949.

57. Treas. Reg. § 1.337-2(b) (1955).

58. See Colborn, Fleming, Katcher, and Merritt, *supra* note 46, at 140. *But cf.* Rev. Rul. 56-541, 1956-2 CUM. BULL. 189 where nonrecognition is upheld though shareholders who owned 80% of the shares of the liquidating corporation subsequently acquired 45% of the shares of the new corporation formed.

59. Nonrecognition of gain or loss applies to all property except for the limitations expressed in § 337(b). Treas. Reg. § 1.337-2(b) (1955). The limitations will be discussed later.



All dispositions of corporate assets are not sales or exchanges for section 337 purposes. An involuntary conversion because of fire was held not to be a sale or exchange for section 337 purposes even though it was treated as a sale by section 1231.<sup>60</sup> However, it has been held that the liquidation proceeds of a subsidiary corporation distributed to a parent corporation, which was in process of liquidation under section 337, were received by the parent in *exchange* for shares of stock surrendered by the parent.<sup>61</sup> Even though such surrender of stock may not normally be thought of as a sale or exchange, section 331 was used as a basis for this ruling. Rev. Rul. 56-372<sup>62</sup> was distinguished from this later ruling in that section 1231 merely treats an involuntary conversion as a sale or exchange for certain purposes mentioned therein; whereas section 331 seems to establish definitions which are to be used in applying the subsequent sections (such as section 337) on corporate liquidation. It has also been held that no gain or loss will be recognized on a condemnation award.<sup>63</sup> Rev. Rul. 57-482<sup>64</sup> holds that cancellation of a bad debt reserve upon liquidation will give rise to ordinary income to the corporation.

The regulations<sup>65</sup> have established several rules to determine whether the sale or exchange occurred within the 12 month period following adoption of the plan of liquidation, as required by section 337. Here we are not necessarily concerned with when the 12-month period begins and ends (as discussed above) but we are considering when the sale or exchange itself was made.

Sales made *before* the adoption of the plan are considered to be made during the 12-month period if such sales are made on the same day the plan is adopted.<sup>66</sup> The regulations<sup>67</sup> show an intent to avoid *Court Holding Co.* type decisions in this area. The rule is very flexible in allowing negotiations to occur and even an executory contract to be made prior to adoption of the plan of liquidation. It probably would be advisable, though, in such executory contracts, to expressly make an adoption of a plan of complete liquidation by the shareholders a condition precedent to the seller's duty to sell and the buyer's duty to buy. Such a contract is expressly stated by the regulations<sup>68</sup> to be "ordinarily" not a sale. The word "ordinarily" used here does, however, create some degree of uncertainty. To be absolutely safe it would

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60. Rev. Rul. 56-372, 1956-2 CUM. BULL. 187.

61. Rev. Rul. 57-243, 1957-1 CUM. BULL. 116.

62. 1956-2 CUM. BULL. 187.

63. Special Ruling, April, 1957, CCH 1958 STAND. FED. TAX REP. ¶ 6574. This ruling involves a twenty-family tenement which was taken by right of eminent domain by the City of New York. This is the only authority for viewing condemnation as a sale or exchange for § 337 purposes. However, see *Commissioner v. Kieselbach*, 127 F.2d 359 (3d Cir. 1942), *aff'd on another issue*, 317 U.S. 399 (1943); *Hawaiian Gas Products v. Commissioner*, 126 F.2d 4 (9th Cir.), *cert. denied*, 317 U.S. 653 (1942). Both of these cases upheld condemnation as a sale for other purposes under the INT. REV. CODE OF 1939.

64. 1957-2 CUM. BULL. 49.

65. Treas. Reg. §§ 1.337-1, -2(a) (1955).

66. Treas. Reg. § 1.337-1 (1955).

67. Treas. Reg. § 1.337-2(a) (1955).

68. *Ibid.*

probably be best not to try to take advantage of either of the above provisions and to go no farther than preliminary negotiations, i.e., not do anything that could be construed as a sale, until after the shareholders have adopted a plan of complete liquidation.

#### NONRECOGNITION OF LOSS

Congress passed section 337 to eliminate uncertainties existing under the *Court Holding Co.* and *Cumberland* cases. The section is clearly aimed at correcting problems that arise concerning gains. However, the section provides for non-recognition of losses as well. It has been discussed above how such provision may be used by the Commissioner's fictitiously moving the date of adoption of a plan of liquidation back to an earlier date when sale of a "loss-asset" was made and thereby forcing nonrecognition of such loss at the corporate level, or allowing recognition of such loss and forcing recognition of gain along with it at the corporate level. But why did Congress want to force such nonrecognition of loss where there has been compliance with section 337?

One writer<sup>69</sup> proposes that the true accounting picture for determination of gain or loss can only be the entire life of the corporation. Also, he says that Congress merely intended to give corporations windfalls regarding gains on assets sold in liquidation and therefore it is inequitable to deprive a liquidating corporation of its loss deduction. Since it has overpaid prior year's taxes by not recognizing these losses when they economically occurred, such corporation should be allowed to deduct its loss. This article presents some excellent arguments why losses should be recognized and not be included in section 337. However, the section reads the other way and therefore it is necessary to consider problems that may arise under it.

The most serious problem created by such nonrecognition of loss arises when substantially all of the assets, of a corporation that wishes to liquidate, will produce a loss when sold. Section 337 affects a corporation when ever such corporation happens to have adopted a plan of complete liquidation and to have distributed its assets in complete liquidation within 12 months; there is no provision requiring a corporation to elect, or permitting a corporation to reject, being under the rules of this section. The result is a serious "trap for the unwary".

If a corporation accidentally meets the provisions of section 337 and sells all its assets at a loss (deducting the loss from income of the present and/or prior years), it could find itself in an unfortunate situation when the Commissioner takes the position that the loss is not recognized under the provisions of section 337.

There are two ways to avoid such nonrecognition of loss, if the corporation is aware of the existing danger and seeks advice from competent counsel early enough: (1) it can sell substantially all of its assets and then wait longer than 12 months before distributing its remaining assets in complete liquidation to the shareholders; or

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69. Gilliam, *Some Effects of Nonrecognized Losses on Corporations and Their Shareholders*, 35 N.C.L. REV. 31, 37-44 (1956).

(2) it can adopt a plan of complete liquidation and not sell the assets, or make final distribution to the shareholders, until after the 12 month period has elapsed.

In using either method, it would seem advisable to wait a substantial amount of time after the 12 month period has elapsed before making final distribution, so that such delay could not be held to be a mere technicality or formality and thereby result in nonrecognition of loss despite the above efforts. The greatest danger exists in example (1); therefore, it may be advisable to make a *number of sales*, stringing out the dates of such sales to cover a period substantially longer than 12 months.

#### LIQUIDATION THROUGH THE MISSOURI COURTS

It is unfortunate that section 337 does not make special provision for corporate liquidations accomplished through the courts.<sup>70</sup> It seems that it would be very difficult to qualify for the benefits of section 337 if the corporate liquidation is handled by the equity courts under the Missouri statutes.<sup>71</sup>

Is there an *adoption by the corporation* of a plan of complete liquidation? If such adoption can be found, when does it occur?

It seems rather difficult to find an adoption of a plan of complete liquidation at the point when the action resulting in dissolution is filed under Missouri statutes.<sup>72</sup> Except for the provision allowing voluntary use of the courts after the corporation has filed articles of dissolution, all the situations listed in the statute<sup>73</sup> where the equity courts are given jurisdiction over corporate dissolutions involve *involuntary* dissolution.

It would seem rather difficult to find that the *corporation adopted a plan* of complete liquidation under section 337 in these situations. Aside from the exception noted in the above paragraph, there has been no action taken by the corporation as such. Also, the word "adopts" in section 337 seems to connote a voluntariness on the corporation's behalf. With these two elements lacking, it seems that the corporation would not be able to comply with section 337 at this point in the equity proceedings.

Also, it is difficult to find that a plan of complete liquidation has been adopted when the corporation is put into the hands of the court, since under Missouri statute<sup>74</sup> the liquidation proceedings may be stopped under certain circumstances. If the suit shall have been instituted by a shareholder or by a creditor, under certain conditions the "liquidation of the assets and business of a corporation may be

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70. Rev. Rul. 56-387, 1956-2 CUM. BULL. 189 eliminates the use of § 337 when all of the corporation's assets are used to pay its creditors. This ruling, in itself, precludes many corporate liquidations which are brought about through the courts from receiving § 337 benefits.

71. §§ 351.485-.515, RSMo 1949.

72. § 351.485, RSMo 1949.

73. *Ibid.*

74. § 351.505, RSMo 1949.

discontinued at any time during the liquidation proceedings."<sup>75</sup> If the suit is brought under any of the remaining provisions in the statutes, there does not seem to be any great problem in finding adoption of a plan of *complete* liquidation if an adoption, itself, can possibly be found at the point of the institution of the action.

As to the exception noted above where the corporation may voluntarily have its "liquidation continued under the supervision of the court,"<sup>76</sup> a different problem arises at the time when the corporation applies for such court action. Before the corporation can seek the aid of the courts, it must first file articles of dissolution. The adoption of a plan of complete liquidation would probably be held to have been made at the time such articles are filed; therefore, it is not necessary to consider whether such adoption may be implied from the corporation's application for the court's assistance. There are other problems, however, arising under this voluntary situation that may prevent the use of section 337. These will be discussed below.

If adoption of a plan of complete liquidation for section 337 purposes cannot be found at the point of institution of an action forcing liquidation or dissolution, there seems to be no other subsequent, identifiable event upon which such adoption can be found. The statutes provide that when the debts have been paid and the assets distributed to the shareholders (or, where there are not enough assets even to pay the debts, the assets have been applied to the debts as far as they go) "the court shall enter a decree dissolving the corporation, whereupon the existence of the corporation shall cease."<sup>77</sup> Of course, at this point, even if the necessary adoption could be found, the corporation cannot avail itself of section 337 because the distribution in complete liquidation as required by section 337 has occurred *before* adoption of the plan.

There seems to be no other intermediate step at which adoption of a plan of complete liquidation may be found except, possibly, for the situation where the court "may" appoint a receiver.<sup>78</sup>

Can an adoption of a plan of complete liquidation be found at the point when the court appoints a "liquidating receiver"?<sup>79</sup> There possibly could be found an adoption of a plan of liquidation at this point since the court has already heard the evidence and decided to liquidate the corporate assets. Again, however, the corporation has not adopted the plan, and it would be difficult to find a plan of *complete* liquidation since under certain situations the proceedings may still be discontinued.<sup>80</sup>

Under Missouri statutes, if a receiver is appointed by the court, he has authority to sell assets of the corporation, pay the liabilities, distribute any remaining assets to the shareholders, and sue or defend in all courts on behalf of the corporation.<sup>81</sup> If

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75. *Ibid.*

76. § 351.485, RSMo 1949.

77. § 351.510, RSMo 1949.

78. § 351.490, RSMo 1949.

79. *Ibid.*

80. § 351.505, RSMo 1949.

81. § 351.490, RSMo 1949.

no adoption of a plan of complete liquidation can be found at an earlier point in the proceedings, there is a possibility that one could be found here (*after* the receiver has been appointed). Of course, the provision for discontinuance of these equity proceedings must still be dealt with in most situations at this point.<sup>82</sup>

The receiver here has a very broad authority in handling the corporate assets. He can do just about anything that the corporation itself could do toward its own liquidation. He is not the "corporation" as required in section 337 but his broad authority here may lead the courts to view him as the "corporation" for purposes of section 337. It would probably be easy to find an *adoption* of a plan of liquidation by the receiver since his sole function is to liquidate, and distribute to the shareholders, the assets of the corporation. He is given authority by the courts to liquidate the corporation's assets; therefore, he surely is authorized to adopt some plan of liquidation.

Whether the receiver can be *forced* to comply with section 337 is doubtful. It seems that one of the most important reasons for establishing a receivership is to have some *independent* party bring about the liquidation of the corporation. Therefore, it would be difficult to forsee the courts' allowing some *interested* party to dictate to the receiver. The receiver surely has some duty to preserve the assets of the corporation, but it seems questionable whether someone could force the receiver to take the affirmative steps required to comply with section 337.<sup>83</sup>

The Missouri statutes say that the "courts shall have all the ordinary powers of a court of equity . . . to take such . . . proceedings as may be requisite to preserve the corporate assets and carry on the business of the corporation *until a full hearing can be had*."<sup>84</sup> (Emphasis added.) This seems to be the only provision in the statutes on dissolution<sup>85</sup> that mentions preserving the corporate assets (which could be construed to include compliance with section 337 if compliance is possible); however, this provision only applies to action that can be taken *up to the point when the court decides to liquidate* the assets of the corporation. There is nothing in the statutes that provides for preservation of assets *during the actual liquidation*.

Even if it could be found that adoption of a plan of complete liquidation had been made by the "corporation", it would still seem difficult to comply with the 12 month requirement in section 337 where the liquidation is brought about through the

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82. The corporation, itself, could adopt a plan of liquidation at any stage in the proceedings. It may be argued that such adoption would technically satisfy § 337 requirements regarding *adoption*; however, the section provides also that "no gain or loss shall be recognized to such corporation from the sale or exchange by it" (emphasis added) and therefore, unless it can be found that the court or receiver is *the corporation*, which is doubtful, there has been no compliance with § 337. This same problem arises whenever an *adoption* can be found at any point in the court proceeding, i.e., not only must the *corporation* adopt the plan of liquidation, but also the *corporation* must *sell or exchange* the assets.

83. For the same reasons, it is questionable whether the receiver can be forced to take the route established by the *Cumberland* case.

84. § 351.490, RSMo 1949.

85. §§ 351.485-.515, RSMo 1949.

courts. If adoption is found at the point of institution of the suit, it seems unlikely that the proceedings will progress, within 12 months, to the point where distribution is made to the shareholders. Where the corporation voluntarily applies to the courts for continuance of liquidation proceedings, the problem is even more acute in this respect because the adoption would most likely be viewed as being made at a time earlier than the point when application is made to the courts.

If it is possible to find an adoption that satisfies section 337 at the point when the receiver assumes control of the corporate assets or at some time while the receiver is in control, the 12 month requirement could possibly be more easily met. However, since the receiver probably cannot be forced to comply with section 337, the corporation cannot rely with any degree of certainty upon the 12 month requirement being met.

Also, it must not be forgotten that an appeal at any stage of the proceeding, after which an adoption has been found and before which distribution in complete liquidation is made, will most likely make it impossible to comply with the 12 month requirement in section 337. If an appeal is taken, our court system and the overcrowded condition of the dockets would seem to make it impossible to liquidate and distribute the corporate assets to the shareholders within 12 months from any identifiable point at which an adoption can be found.

The intention of Congress, in establishing the 12 month period in section 337, was probably to insure that when a corporation adopted a plan of liquidation complying with section 337, it would be earnest in its efforts to liquidate. If the period had been longer, corporations could stall and manipulate their situations to gain tax advantages while acting under a pretense of liquidation. However, it would be hard to find better evidence of a sincere attempt at liquidation than that shown by putting the corporation in the hands of the courts for the express purpose of liquidation and dissolution.

Section 337 says "12-months", though, for any and all types of liquidations.<sup>86</sup> It seems to follow that Congress merely did not intend to place the benefits of section 337 within the reach of corporations that are liquidated through the courts.

The effect in Missouri could well be that the use of the courts in liquidation will subside. Where a large gain will result from the sale of the assets of a corporation, a large tax saving would probably be lost by someone if the courts bring about the liquidation. Where the corporation is solvent, the shareholders would probably not want to lose the tax saving. The creditors would also be hesitant to bring the action, because, even if the corporation is solvent before liquidation, there must be enough assets also to pay the tax or the creditors will not obtain the full amount due them. Rev. Rul. 56-387<sup>87</sup> has ruled out section 337 benefits to an insolvent corporation, as

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86. Treas. Reg. § 1.337-1 (1955) says that "no extension of such period can be granted."

87. 1956-2 CUM. BULL. 189.

discussed in note 34, *supra*; therefore, none of the parties involved have a choice when there is insolvency. There exists, here, an area in which Congress, by passing section 337, will probably restrict and diminish the use of remedies provided by the Missouri statutes.

#### DEFINITION OF PROPERTY FOR SECTION 337(a) PURPOSES

Section 337(b) defines "property", as used in section 337(a) so that certain sales or exchanges are treated differently regarding nonrecognition of gain or loss. In effect, the section excludes from nonrecognition of gain or loss, *except* in certain circumstances, the sales of stock in trade, inventory, property held primarily for sale to customers in the ordinary course of business, installment obligations arising from these assets, and installment obligations arising from property sold or exchanged *before* the date of adoption of the plan of complete liquidation.

The section provides, however, that if "substantially all" the stock in trade, inventory, and property held primarily for sale in the ordinary courses of business (all of which will be hereafter referred to as inventory), which are attributable to a trade or business of the corporation, are sold to one person in one transaction, no gain or loss is recognized on *such* sale or exchange and/or on the sale or exchange of installment obligations arising out of *such* sale or exchange.

Congress "intended that, during the 12-month period, sales in the ordinary course of business shall result in ordinary gain to the corporation as if the corporation were not in the process of liquidating."<sup>88</sup> Since bulk sales, as described in section 337(b) (2), are not made in the "ordinary course of business", these sales were expressly left within the reach of nonrecognition of gain or loss.

Section 337(b) (2) is ambiguous as to when the "substantially all" test is to be applied: (1) at the point of adoption of a plan of complete liquidation or (2) at the time the sale is made. The regulations, though, say that "'substantially all' means substantially all of the inventory at the time of the sale."<sup>89</sup> This rule allows the corporation to sell more of its inventory without losing the nonrecognition of gain benefits. The corporation could sell, in the ordinary course of business, almost all of its inventory and still not recognize gain on the last inventory items sold if such last sale was "substantially all" of the inventory on hand *at the time of that last sale*. The regulation<sup>90</sup> seems to permit a corporation to sell its inventory items, which will result in a loss, in the ordinary course of business (deducting such loss), and later make a bulk sale of those items which will produce a gain (not recognizing such gain). Of course, this seems to be in accord with congressional intent since the committee report merely says that sales resulting in "ordinary gain" to the corporation should be treated as if the corporation were not liquidating.<sup>91</sup>

88. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

89. Treas. Reg. § 1.337-3(b) (a) (1955).

90. *Ibid.*

91. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

The regulations state that "‘substantially all’ . . . includes inventory subject to liabilities, specific or otherwise."<sup>92</sup> It seems to follow that if the corporation were to return inventory items in exchange for cancellation of an unpaid bill regarding those items, such transaction would result in the corporation's not selling "substantially all" its inventory items to one purchaser in one transaction.

Section 337 requires that such sale of substantially all of the inventory be made to "one person". However, these words are not to be interpreted literally. Section 7701(a) (1) says: "The term person shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation."<sup>93</sup>

The Senate's version of this part of section 337,<sup>94</sup> originally provided for non-recognition of inventory sales if substantially all of the inventory is sold or exchanged to one person in one transaction. The Conference Committee<sup>95</sup> changed this to what section 337(b) (2) now says, i.e., "if substantially all of the . . . [inventory] *which is attributable to a trade or business*" is sold or exchanged, then no gain or loss will be recognized on such sale or on the sale of an installment obligation arising out of such sale. (Emphasis added.) The Conference Committee explains that if a corporation is engaged in "2 distinct businesses" it may sell substantially all of the inventory of one of the "businesses", not recognizing gain or loss on such sale, even though the inventory of the other "business" is distributed to the shareholders in kind.<sup>96</sup>

The regulations are helpful here. One of the examples illustrating nonrecognition of gain or loss, is a situation where the corporation has two department stores handling the same items and a common warehouse. The regulations say that gain or loss upon a sale of one of the department stores' inventory will not be recognized if the inventory in the warehouse, belonging to that store, can be identified and is sold along with the inventory in the department store.<sup>97</sup> This seems to be a rather broad interpretation of the words "a trade or business" as used in section 337 and the words "distinct businesses" as used in the committee report. Therefore, it would seem that the above example in the regulations is the extreme beyond which the courts will not go in determining whether a corporation has sold "substantially all" the inventory in one of its trades or businesses or whether the corporation has sold only a part of the inventory of one trade or business.

The Senate Committee report<sup>98</sup> and the regulations<sup>99</sup> state that if "substantially all" of the inventory is sold and then the corporation replaces such inventory or a new kind of inventory, section 337(b) (2) cannot be used; the result being that gain

92. Treas. Reg. § 1.337-3(b) (2) (1955).

93. One problem that may arise here is whether a sale to individuals as tenants in common would be viewed as a "partnership" or as an "association" thereby making such sale a compliance with § 337(b) (2).

94. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

95. CONF. REP. No. 2543, 83d Cong., 2d Sess. 36 (1954).

96. *Ibid.*

97. Treas. Reg. § 1.337-3(d) (3) (1955).

98. S. REP. No. 1622, 83d Cong., 2d Sess. 258 (1954).

99. Treas. Reg. § 1.337-3(b) (1955).



or loss on the sale of all inventory will be recognized. The committee report next states that ordinarily such "bulk sale" will be the "last sale made by the corporation of its inventory."<sup>100</sup>

The big problem remaining in the application of section 337(b) (2) is: What amount of the inventory on hand will be viewed as being "substantially all"?

Again, the intent of Congress was to have ordinary sales of inventory treated as if the corporation were not liquidating, i.e., to have the gain or loss on such sales recognized by the corporation.<sup>101</sup> From this it would seem to follow that gain or loss from a sale of, for example, one-fifth of the corporation's inventory could go unrecognized, since such a sale would not be one that would occur in the ordinary course of business. Did Congress, then, intend that "substantially all" would mean any sale not in the ordinary course of business? The answer is obviously negative since "substantially all" cannot be stretched to mean, for example, *one-fifth* of the corporation's inventory.

The committee, later in the report, says, "Thus, the bulk sale referred to will ordinarily be the last sale made by the corporation of its inventory."<sup>102</sup> This sentence probably refers to the sentence immediately preceding it which considers replacement of inventory sold (as discussed above). However, the sentence dangles near the end of the committee's discussion of section 337(b); therefore, it is possible that it was meant to show what "substantially all" means. If interpreted to be the latter, there seems to be inconsistency within the report itself; therefore, the former interpretation would seem to be correct.

An inconsistency does, though, exist between the *reasons given* for section 337 (b) in the committee report<sup>103</sup> and the *words used* in section 337(b) (2). Therefore the congressional intent as expressed in the committee report does not help much in determining just exactly how much is "substantially all".

There is, possibly, one clue given by the regulations.<sup>104</sup> An example shows a corporation having two department stores with a common warehouse. The inventory in one department store, but none of the inventory in the warehouse, is sold. The "amount of inventory items"<sup>105</sup> in the warehouse, belonging to the store that is sold, equals one-half of the amount in that store itself. In other words, the corporation sold *two-thirds* of the "amount of inventory items" attributable to the one department store. The example is then weakened by the fact that the inventory in the

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100. S. REP. NO. 1622, 83d Cong., 2d Sess. 258 (1954). It is difficult to determine just exactly what this sentence means. It would seem that a corporation with \$1,000,000 of inventory, which sold \$999,900 of it, should be entitled to nonrecognition benefits on such a sale.

101. S. REP. NO. 1622, 83d Cong., 2d Sess. 258 (1954).

102. *Ibid.*

103. *Ibid.*

104. Treas. Reg. § 1.337-3(d) (2) (1955).

105. (Emphasis added.) Another problem arises from the use of the word "items". To determine how much is "substantially all," is the dollar amount or the number of items used?

warehouse cannot be separately identified with each department store. The result indicated is that gain or loss will be recognized upon the sale of the inventory. The noncompliance with section 337(b) (2) could have been (1) that two-thirds of the inventory is not "substantially all" or (2) that the two department stores were not "distinct businesses"<sup>106</sup> because their inventories in the common warehouse were inseparable. There seems to be no way to tell upon which ground nonrecognition of gain or loss was denied in this example.

The third example given by the regulations<sup>107</sup> does not help much either. In this example, both of the possible defects in the preceding example are cured (i.e. the inventory was separated and all of the one store's inventory was sold) and it is stated that no gain or loss will be recognized. From this, however, it cannot be determined whether the curing of one defect or both is necessary to result in such nonrecognition.

Since there seems to be no authoritative explanation, either in the committee reports or in the regulations, of what amount of inventory will be "substantially all", a dangerous area exists in applying section 337(b) (2). To be absolutely safe, it would appear that a corporation should sell *all* of its inventory attributable to a trade or business to one person in one transaction.

Where sale of a corporation's inventory would produce a gain and the corporation is unable to qualify for the use of section 337(b) (2), it would seem advisable to use the *Cumberland* route, if at all possible. However, if the shareholders are widely scattered or the inventory consists of many small items (which is probably the situation in most corporations), it would not seem feasible to accomplish such a distribution.

Where the sale of a corporation's inventory would produce a loss it would seem advisable for the corporation to avoid compliance with section 337(b) (2). It seems that the corporation could safely rely on being able to deduct the loss if all the inventory were sold in the ordinary course of business. The corporation should also be able to deduct such loss if it fails, in any way to meet section 337(b) (2); for example, the corporation could sell its inventory to *two* persons instead of one.

#### INSTALLMENT OBLIGATIONS

Several technical distinctions must be considered when a liquidating corporation holds installment obligations. Section 337(b) (1) provides for *recognition* of gain or loss on the sale of installment obligations that arose out of a sale of inventory in the ordinary course of business, no matter when the sale was made, and on the sale of installment obligations that arose out of a sale of any other corporate asset, if such sale was made before the adoption of the plan of liquidation. Section 337(b) (2) provides, however, for *nonrecognition* of gain or loss on the sale of an installment

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106. Treas. Reg. § 1.337-3(c) (1955).

107. Treas. Reg. § 1.337-3(d) (3) (1955).

obligation which arose out of a sale of inventory where substantially all the inventory attributable to a trade or business was sold, subsequent to adoption of a plan of liquidation, to one person in one transaction. Therefore, the only sales of installment obligations which will qualify for *nonrecognition* are those that arise out of a sale of inventory that meets the requirements of section 337(b)(2) or out of a sale of other assets which was made subsequent to the adoption of the plan of liquidation.

Under section 453(d) a corporation must pay tax on the unreported gain involved in an installment obligation which is distributed to its shareholders. There is an exception, however, where the installment obligation is one which would qualify for nonrecognition of gain if it were sold or exchanged under section 337. This section seems to eliminate use of the *Cumberland* route to avoid taxable income at the corporate level where the installment obligation arose out of a sale of inventory which does not meet section 337(b)(2) or out of a sale of other assets which occurred before the date of adoption of a plan of liquidation.

The treatment of these two types of installment obligations is different from most of the other corporate assets in that the corporation has no choice of methods that will allow *nonrecognition* of gain at the corporate level; it cannot use section 337 or the *Cumberland* route.

#### COLLAPSIBLE CORPORATIONS

Section 337(c)(1)(A) recites that section 337 shall not apply to any sale or exchange made by a collapsible corporation as defined by section 341(b). Section 341(a) provides for taxing shareholders, on certain distributions by collapsible corporations, as if the gain were from a non-capital asset when otherwise it would appear that the gain would qualify for capital gains benefits. It seems that this section virtually ended the manipulation that was occurring by establishing "collapsible corporations". Since Congress apparently intended to eliminate tax savings acquired through such corporate manipulation,<sup>108</sup> it is understandable that the benefits of section 337 are denied to these parties.

#### SECTION 333 LIQUIDATIONS

Section 337(c)(1)(B) provides that section 337 shall not apply to a sale or exchange, following adoption of a plan of complete liquidation, if section 333 applies to such liquidation. Section 333 allows a shareholder, under certain circumstances, to elect not to recognize portions of any gain that would ordinarily be recognized by him.

#### SUBSIDIARY CORPORATION LIQUIDATIONS

The subsections within section 337 that treat subsidiary corporation liquidations present problems which would require an extended discussion, therefore, these provisions will not be discussed in this Comment. It should be noted, however, that

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108. S. REP. No. 1983, 85th Cong., 2d Sess. 31 (1958).

there was an important amendment to section 337 in 1958 which is concerned with the treatment of minority shareholders in the subsidiary corporation situation.<sup>109</sup>

#### MISSOURI STATE INCOME TAX

Since corporation income is also taxable under the Missouri income tax statutes,<sup>110</sup> no corporate gain situation can be thoroughly analyzed without considering the effect of the state tax. Although the tax only amounts to "two per cent of net income,"<sup>111</sup> this amount may be substantial to some corporations.

The Missouri statute seems to provide for a tax credit, to the shareholder of a corporation, against any tax on income derived from the corporation.<sup>112</sup> The tax credit is computed upon the amount of income on which the corporation, itself, paid tax to the state. Apparently, the statute eliminates any double taxation on the amount of income which a corporation earns and distributes to its shareholders.

If the corporation follows the route of the *Cumberland* case, the shareholder will be required to pay the state income tax. The amount of tax the shareholder will be required to pay depends upon the bracket within which the shareholder's total income places him. If the corporation sells the assets and realizes the gains, there will be a two per cent tax payable by the corporation, and, theoretically, none paid by the shareholder if the shareholder is in a tax bracket of two per cent or lower; however, since the credit to the shareholder is, actually, only the amount of *tax paid by the corporation*, if the shareholder is in a higher bracket than two per cent, the shareholder must pay the amount of tax normally due from him which is greater than the amount of tax the corporation has paid.

Therefore, when the shareholders are all in brackets higher than two per cent, it appears that there is no difference between using a section 337 liquidation or a liquidation following the *Cumberland* route; however, if the shareholders are all in brackets below two per cent, it would appear that liquidation via the *Cumberland* route would be financially beneficial. It would seem, though, that determination of the tax brackets of all the shareholders may be a task unworthy of the possible tax saving to be achieved (at most two per cent of net income), unless the net income of the corporation is a fairly large sum and/or the corporate shares are closely held. Also, whenever the *Cumberland* route is employed, the corporation and the shareholders must be willing to bear the risks involved in federal income tax consequences.

#### PRECAUTION IN USING CUMBERLAND ROUTE

Whenever the *Cumberland* route is used by a corporation (as suggested above in certain circumstances), it would probably be advisable for the corporation to adopt a plan of complete liquidation before the assets are distributed to the shareholders. It

109. Section 337(d).

110. § 143.030, RSMo 1949.

111. *Ibid.*

112. § 143.150, RSMo 1949.

is still possible that a sale of these assets made by the shareholders will be viewed as a sale by the corporation.<sup>113</sup> If such is held, the corporation will be required to pay a tax on the gain produced by such sales unless the corporation has complied with section 337 and can qualify for the nonrecognition benefits.<sup>114</sup>

#### CONCLUSION

Reverting to the example given in the first paragraph of this Comment, it is apparent that the corporation could save up to \$520,000 if it took the necessary steps to qualify for section 337 benefits *and* if it was able to avoid the many traps along the way. The most important steps, in using section 337, are the adoption of a plan of complete liquidation and the compliance with the 12 month requirement for distribution to the shareholders in complete liquidation (both of which must necessarily be considered together). These two steps are most important because noncompliance with either requirement will result in recognition of the *total* gain produced by the sales of *all* corporate assets. The inventory aspects of section 337 are usually important in that generally the amounts involved will be large. Since the handling of inventory items is fairly complex, under section 337, the situation should be thoroughly scrutinized before any corporate action is undertaken. Of course, the inventory provisions in section 337 do not threaten complete recognition of gain on *all* assets, but, at most, if not met, the gain on inventory *alone* will be taxed at the corporate level.

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113. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

114. Technically, it seems possible for the courts to hold that such gain, forcibly recognized by the corporation, is not covered by § 337 because the section only applies to gain or loss made on sales *by the corporation*. It is extremely doubtful that the courts would revert the sale to the corporation for one purpose and then hold that the sale was not made by the corporation for § 337 purposes; but it is remotely possible.